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SMALL BUSINESS ADMINISTRATION

13 CFR Part 107

RIN 3245-AG57

Small Business Investment Companies – Investments in Passive Businesses

AGENCY: U.S. Small Business Administration.

ACTION: Final rule.

SUMMARY: In this final rule, the U.S. Small Business Administration (SBA) is revising the regulations for the Small Business Investment Company (SBIC) program concerning investments in passive businesses. SBICs are generally prohibited from investing in passive businesses under the Small Business Investment Act of 1958, as amended, as well as under SBIC program regulations. This final rule modifies an exception that allows an SBIC to make an investment in a passive small business that passes through the investment proceeds to one or more subsidiaries, each of which must be a non-passive small business. This modification allows an SBIC to structure an investment utilizing two levels of passive small businesses as pass-through entities under specific circumstances. The purpose of the modification is to place SBICs on a more equal footing with their non-SBIC counterparts in the venture capital and private equity sectors, in which investments structured with two passive levels are not uncommon.

This final rule also includes several technical corrections. Specifically, the final rule updates the regulations by replacing obsolete Standard Industrial Classification (SIC) codes with their equivalents under the North American Industrial Classification System

(NAICS); corrects erroneous paragraph cross-references; and modernizes the options for meeting the record preservation requirements by removing the reference to “microfilm.”

DATES: This rule is effective [INSERT DATE 30 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER].

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SUPPLEMENTARY INFORMATION:

I. Background Information

The Small Business Investment Act of 1958, as amended, prohibits an SBIC from making passive investments. Accordingly, SBA promulgated 13 CFR 107.720(b), which states as a general rule that an SBIC is not permitted to finance a passive business. The regulation defines a business as passive if: (1) it is not engaged in a regular and continuous business operation; (2) its employees do not carry on the majority of day-to-day operations, and the company does not exercise day-to-day control and supervision over contract workers; or (3) the business passes through substantially all financing proceeds to another entity.

Prior to this final rule, §107.720(b) provided two exceptions to the general prohibition that allow SBICs to employ certain structures in which the direct recipient of financing is a passive business, but the end recipient is an active business. The first exception, identified in §107.720(b)(2), provided that an SBIC may make an investment in a passive small business that passes through the investment proceeds to one or more subsidiary companies, each of which must be a non-passive small business. SBA defined

a subsidiary company as one in which the financed passive business *directly* owns at least 50 percent of the outstanding voting securities. The 50 percent ownership requirement was promulgated in 1998 (63 FR 5859, February 5, 1998), replacing an earlier provision that allowed a passive small business to be financed only if it passed the financing proceeds through to a wholly-owned small business subsidiary. In addressing comments suggesting that SBA should drop the ownership requirement altogether, the 1998 final rule stated, “SBA believes that when a Licensee makes an investment in a holding company which is unrelated to the Licensee and is, in fact, a portfolio company, the requirement that proceeds be passed through only to 50 percent-owned subsidiaries should remain. This provision ensures that there is a significant relationship between the financed passive business and the active businesses which ultimately receive the proceeds, and that the passive business is not functioning simply as a re-investor.” The Small Business Investment Act prohibits an SBIC from financing “relenders or re-investors.”

The same final rule also established a second exception, promulgated as §107.720(b)(3), which allows an SBIC organized as a partnership to form, with SBA’s prior approval, a passive wholly-owned corporation, the sole purpose of which is to serve as a conduit for financing provided to one or more eligible unincorporated small businesses. An SBIC may form such a corporation only if a direct financing of the small business would cause any of the SBIC’s investors to incur unrelated business taxable income (UBTI) under section 511 of the Internal Revenue Code of 1986, as amended (26 U.S.C. 511). A corporation formed for this purpose is one example of what is commonly referred to as a “blocker corporation” to denote an entity that is subject to Federal

corporate income tax and is intended to shield an investor from certain types of tax liability (most typically UBTI for a tax-exempt investor or “effectively connected income” for a foreign investor).

In promulgating §107.720(b)(3), SBA recognized that financing proceeds flowing from an SBIC to its wholly-owned subsidiary (an “Associate” under §107.50) would technically represent a prohibited conflict of interest under §107.730(a); the 1998 final rule addressed this issue by specifically providing that funds invested by an SBIC in a blocker corporation created under §107.720(b)(3) would not constitute a violation of §107.730(a). Similarly, the 1998 final rule provided that an SBIC’s 100 percent ownership of a blocker corporation would not constitute a violation of §107.865(a), which limits SBIC control over a Small Business, but the need for this provision was essentially eliminated by the relaxation of the regulatory restrictions on control in 2002.

On December 23, 2013, SBA published a proposed rule (78 FR 77377) to expand the holding company exception set out in §107.720(b)(2), by modifying the definition of a subsidiary company to allow financing proceeds to pass through a second passive business before reaching a non-passive subsidiary. The proposed definition did not change the requirement that a passive direct recipient of SBIC financing own at least 50% of the active business that ultimately receives the proceeds (or that the proceeds are used to acquire); rather it allowed for indirect ownership through a second passive Small Business. The preamble to the proposed rule discussed how this change would allow SBICs to have greater flexibility in structuring transactions typically employed by other private equity and venture firms. The proposed rule also included several technical corrections.

SBA received one set of comments on the proposed rule. These are discussed in the following section-by-section analysis.

II. Section-by-Section Analysis

A. Passive Business Rules

The proposed rule expanded the definition of subsidiary company in §107.720(b)(2) to allow financing proceeds to pass through a second passive business before reaching a non-passive subsidiary.

The commenter supported the expansion of the passive investment exceptions and described transaction structures that the commenter believed would be permitted under the proposed rule. SBA agrees with the commenter that the proposed rule would allow SBICs to “finance a passive business to take advantage of the favorable tax treatment under Internal Revenue Code §338(h)(10)” and “invest in an operating company through two passive business holding companies, subject to certain requirements.” The preamble in the proposed rule specifically discussed these two instances.

The commenter believed that the proposed rule would also allow an SBIC to create a blocker corporation as one of the two permitted levels of passive businesses under proposed §107.720(b)(2), for the following purposes: (1) to shield tax exempt investors from receiving unrelated business taxable income (UBTI) from an investment in a flow-through entity; (2) to protect an SBIC’s foreign investors from the taxation imposed on income that is considered to be “effectively connected” to a U.S. trade or business; and (3) in the case of an SBIC that either is a BDC licensed under the Investment Company Act of 1940 or is owned by a parent BDC, to avoid jeopardizing the

BDC's qualification as a regulated investment company under the Internal Revenue Code.

The commenter's interpretation of the proposed revision of §107.720(b)(2) is correct, provided the financing proceeds are passed through only to one or more non-passive "subsidiary companies" as defined in that section. Proposed §107.720(b)(2) did not specify any purpose for which a passive entity may or may not be utilized. Thus, SBA's view is that an investment that is otherwise eligible under §107.720(b)(2) could include a passive entity that serves one of the tax-avoidance purposes cited by the commenter. SBA reminds SBICs, however, that §107.720(b)(2) does not permit any investment in which the first-level passive entity does not own, either directly or indirectly, at least 50 percent of the outstanding voting interests of the active small business that ultimately receives the financing proceeds.

Furthermore, it is important to note that the proposed rule did not include any expansion of §107.720(b)(3), which governs the formation and use of blocker corporations and which does not include any percentage of ownership requirement comparable to the "subsidiary company" requirement in §107.720(b)(2). SBA did not intend to permit the formation and use of blocker corporations under §107.720(b)(3) for any purpose other than the avoidance of UBTI as permitted by the existing regulation.

The commenter also suggested the following changes to further liberalize permitted financings to passive businesses under §107.720(b):

(1) Revise §107.720(b)(2) to explicitly state that an SBIC may "form and finance" (rather than merely "finance") a passive business.

(2) Eliminate the requirement for SBA prior approval to form a blocker corporation under §107.720(b)(3).

(3) Revise §107.720(b)(3) to permit an SBIC to form a blocker corporation to enable its foreign investors to avoid “effectively connected” income.

(4) Further broaden §107.720(b)(2) to allow SBICs to structure financings in which proceeds may pass through an unlimited number of passive entities before reaching an eligible, non-passive small business.

The final rule does not adopt these changes. For the reasons discussed below, SBA may consider the first three suggestions for future rulemaking, but is opposed to allowing investments to be structured with more than two passive levels.

Regarding the suggestion to allow an SBIC to “form” a passive holding company under §107.720(b)(2), SBA acknowledges that some SBICs may already be providing financing to holding companies in which they own a controlling equity interest, in compliance with the provisions of existing §§107.865 and 107.720. Thus, the addition of “form” to §107.720(b)(2) may not represent a significant change. However, SBA wishes to further evaluate this change before proposing it in any future rulemaking.

SBA may consider the two suggested changes to §107.720(b)(3) in future rulemaking provided that additional safeguards are included to address SBA concerns regarding credit risk, specifically SBA’s ability to collect from SBICs that default on their debt to SBA. Even under §107.720(b) as it existed prior to this final rule, SBA has encountered three issues that affect its recoveries from defaulting SBICs with assets that are held indirectly through a passive company: (1) SBA’s lack of access to the books and records of the passive company; (2) fees and expenses charged at each level, diverting

money from the actual investment and returns; and (3) greater opportunity for disproportionate distributions to entities other than the SBIC, thereby reducing the funds available to repay SBA. SBA expects that any future rulemaking to expand the permitted financing of passive businesses (under either §107.720(b)(2) or (b)(3)) would include provisions to address these concerns.

The commenter's suggestion to allow more than two levels of passive holding companies under §107.720(b)(2) stated that "the crucial concept should be that the operating company receives substantially all the proceeds that the SBIC is investing." While this concept is perhaps valid with respect to the SBIC program's public policy objectives, SBA believes that it would be problematic to implement in practice, precisely because of the credit and oversight concerns cited in the preceding paragraph. Even with potential new regulatory protections that would address these concerns, SBA believes that effective monitoring of transactions with multiple levels of passive companies would require resources well beyond those available to the Agency.

Despite its concerns about the potential risks associated with investments structured with passive entities, SBA is finalizing this rule at the request of SBICs so that they may participate in a broader range of financing transactions from which small businesses will benefit. SBA expects that SBICs will exercise due diligence and appropriate monitoring to ensure that passive companies do not charge excessive fees or expenses so that maximum funding is provided to the active small business investment and returns to the SBIC are not adversely affected. As previously noted in this preamble, SBA intends to take into account its experience with such structures in future rulemaking.

The commenter also noted a potential source of confusion in proposed §107.720(b)(2)(ii). This section was intended to allow an SBIC to route financing proceeds to an active small business through two levels of passive holding companies, as long as the first holding company owns at least 50 percent of the outstanding voting securities of the active company. The commenter suggested that the stated requirements for a minimum of 50 percent ownership at each level (i.e., the first passive holding company must own at least 50 percent of the second, which must own at least 50 percent of the active company) could be misinterpreted as requiring only 50% ownership at each level. This incorrect reading could result in as little as 25 percent ownership of the active company by the first passive holding company. The commenter's suggestion was to delete the intermediate ownership percentage requirements and retain only the requirement for at least 50 percent ownership of the active company by the first passive company. SBA agrees with this clarification and has adopted it in the final rule.

The commenter also noted that §107.720(b)(2)(i) and (ii) define the 50 percent ownership requirement in terms of "outstanding voting securities". The commenter suggested that SBA confirm that the regulation encompasses both the "securities" of a corporation and the "interests" of a limited liability company or limited partnership. SBA confirms that the regulation is intended to refer to both "securities" and "interests" as described by the commenter. SBA has retained the ownership requirement based on "outstanding voting securities" in the final rule to remain consistent with other regulations (e.g., §107.865(a)) that similarly refer to "voting securities" and are understood to include interests of limited liability companies and limited partnerships.

B. Technical Changes to Regulations

SBA received one comment on the technical changes in the proposed rule. The commenter noted that the proposed change to §107.720(c) mistakenly reverses the descriptions of NAICS codes 531110 and 531120. SBA has corrected this in the final rule. Otherwise, all of the technical changes have been finalized as proposed, and additional cross-references have been corrected in the final rule. SBA's section-by-section explanation of the changes is repeated here as a convenience to the reader.

Section 107.600 – General requirement of Licensee to maintain and preserve records.

The record-keeping requirements applicable to SBICs are found primarily in §107.600. This section enumerates various types of records and the periods for which they must be preserved. The final paragraph of the section, §107.600(c)(4), allows an SBIC to substitute “a microfilm or computer-scanned or generated copy” for any original paper record. The final rule modernizes this provision by deleting the reference to “microfilm” as a preservation medium.

Section 107.720 – Small Businesses that may be ineligible for financing.

Real Estate Businesses. Under the prior §107.720(c), an SBIC was not permitted to finance “any business classified under Major Group 65 (Real Estate) or Industry No. 1531 (Operative Builders) of the SIC Manual” with exceptions provided for certain businesses that provide services within the real estate industry (such as title abstract companies). The “SIC Manual” refers to the Standard Industrial Classification system formerly used by Federal statistical agencies in classifying business establishments for the purpose of collecting, analyzing, and publishing statistical data related to the U.S. business economy. In 1997, the Federal government replaced the SIC codes with the North American Industrial Classification System (NAICS).

The final rule updates 13 CFR 107.720(c) by replacing SIC codes with their 2012 NAICS equivalents, which duplicate the previous general prohibitions and permitted exceptions as closely as possible. The following tables show each of the SIC codes referenced in the current regulation and the NAICS code that SBA has replaced it with.

Crosswalk from SIC Codes to NAICS Codes

Prohibited Investments:	
SIC Code	NAICS Code
6512 Operators of nonresidential buildings	531120 Lessors of nonresidential buildings (except miniwarehouses)
6513 Operators of apartment buildings 6514 Operators of dwellings other than apartment buildings	531110 Lessors of residential buildings and dwellings
6515 Operators of residential mobile home sites 6517 Lessors of railroad property 6519 Lessors of real property, not elsewhere classified	531190 Lessors of other real estate property
6552 Land subdividers and developers, except cemeteries	237210 Land subdivision
1531 Operative builders	236117 New housing for-sale builders 236118 Residential remodelers ¹ 236210 Industrial building construction ¹ 236220 Commercial and institutional building construction ¹

¹ An SBIC may not finance a Small Business classified under this code if such business is primarily engaged in construction or renovation of properties on its own account rather than as a hired contractor.

Restricted Investments:	
SIC Code	NAICS Code
6531 Real estate agents and managers (establishments primarily engaged in renting, buying, selling, managing, and appraising real estate for others)	531210 Offices of real estate agents and brokers 531311 Residential property managers 531312 Nonresidential property managers 531320 Offices of real estate appraisers 531390 Other activities related to real estate
Permitted only if business derives at least 80% of its revenue from non-Affiliate sources.	Permitted only if business derives at least 80% of its revenue from non-Affiliate sources.

Permitted Investments:	
SIC Code	NAICS Code
6541 Title abstract offices	541191 Title abstract and settlement offices

The only SIC code in the previous regulation that did not correspond directly to one or more NAICS codes is 1531, “Operative builders.” The SIC Manual described this industry as consisting of establishments primarily engaged in the construction (including renovation) of single-family houses and other buildings for sale on their own account rather than as contractors. The industry included speculative builders and condominium developers. The 2012 NAICS codes primarily use the term “for-sale builder” to describe businesses engaged in construction or renovation of buildings on their own account. However, except for those engaged in new housing construction (NAICS code 236117), for-sale builders are combined with contractors in three different NAICS codes, depending on whether they are engaged in residential remodeling (NAICS code 236118), manufacturing/industrial building construction (NAICS code 236210), or commercial/institutional building construction (NAICS code 236220). The final rule prohibits an SBIC from providing financing to a Small Business classified under any of these three NAICS codes only if the company is primarily engaged in construction or renovation of buildings as a for-sale builder. Guidance provided by the United States Census Bureau indicates that the key element of a for-sale builder is whether a firm is engaged in construction on its own account, as opposed to having been hired as a contractor. For example, the final rule permits an SBIC to provide financing to a firm that primarily renovates or builds additions to homes if the homeowners have contracted for the firm’s services. However, a firm that primarily acquires homes to renovate and

re-sell at its own risk is a “for-sale remodeler” that would not be eligible for financing by an SBIC.

Section 107.1120 – General eligibility requirements for Leverage, and section 107.1150 – Maximum amount of Leverage for a Section 301(c) Licensee.

The final rule corrects erroneous paragraph references in §§107.1120 and 107.1150, which set forth leverage eligibility provisions for SBICs. Some of these erroneous references were not identified in the proposed rule, but are nevertheless finalized in this rule because they are merely corrections that do not substantively change the subject regulations.

Compliance with Executive Orders 12866, 12988 and 13132, the Paperwork Reduction Act (44 U.S.C. Ch. 35) and the Regulatory Flexibility Act (5 U.S.C. 601-612)

Executive Order 12866

The Office of Management and Budget has determined that this final rule is not a “significant” regulatory action under Executive Order 12866. This is also not a “major” rule under the Congressional Review Act, 5 U.S.C. 801, et seq.

Executive Order 12988

This action meets applicable standards set forth in section 3(a) and 3(b)(2) of Executive Order 12988, Civil Justice Reform, to minimize litigation, eliminate ambiguity, and reduce burden. The action does not have retroactive or presumptive effect.

Executive Order 13132

The rule does not have substantial direct effects on the States, or the distribution of power and responsibilities among the various levels of government. Therefore, for the

purposes of Executive Order 13132, Federalism, SBA determines that this final rule has no federalism implications warranting the preparation of a federalism assessment.

Paperwork Reduction Act, 44 U.S.C. Ch. 35

For purposes of the Paperwork Reduction Act, 44 U.S.C. Ch. 35, SBA has determined that this final rule does not impose any new reporting or recordkeeping requirements.

Regulatory Flexibility Act, 5 U.S.C. 601-612

The Regulatory Flexibility Act (RFA), 5 U.S.C. 601, requires administrative agencies to consider the effect of their actions on small entities, small non-profit businesses, and small local governments. Pursuant to the RFA, when an agency issues a rule, the agency must prepare an Initial Regulatory Flexibility Act (IRFA) analysis which describes whether the impact of the rule will have a significant economic impact on a substantial number of small entities. However, section 605 of the RFA allows an agency to certify a rule, in lieu of preparing an IRFA, if the rulemaking is not expected to have a significant economic impact on a substantial number of small entities. This final rule would affect all SBICs, of which there are currently close to 300. SBA estimates that approximately 75% of these SBICs are small entities. Therefore, SBA has determined that this final rule does have an impact on a substantial number of small entities. However, SBA has determined that the impact on entities affected by the rule is not significant. The passive business provision provides SBICs with additional flexibility to employ a transaction structure commonly used by private equity or venture capital funds that are not SBICs.

SBA asserts that the economic impact of the rule, if any, is minimal and entirely beneficial to small SBICs. Accordingly, the Administrator of the SBA certifies that this final rule will not have a significant impact on a substantial number of small entities.

List of Subjects in 13 CFR Part 107

Investment companies, Loan programs-business, Reporting and recordkeeping requirements, Small businesses.

For the reasons stated in the preamble, the Small Business Administration amends part 107 of title 13 of the Code of Federal Regulations as follows:

PART 107 - SMALL BUSINESS INVESTMENT COMPANIES

1. The authority citation for part 107 continues to read as follows:

Authority: 15 USC 681 et seq., 683, 687(c), 687b, 687d, 687g, 687m, and Pub. L. 106-554, 114 Stat. 2763; and Pub. L. 111-5, 123 Stat. 115.

§ 107.50 [Amended]

2. Amend § 107.50 by removing the definition of “SIC Manual”.
3. Revise §107.600(c)(4) to read as follows:

§ 107.600 General requirement for Licensee to maintain and preserve records.

* * * * *

(c) * * *

(4) You may substitute a computer-scanned or generated copy for the original of any record covered by this paragraph (c).

4. Amend §107.720 by revising paragraphs (b)(2) and (c)(1) and the introductory text of paragraph (c)(2) to read as follows:

§ 107.720 Small Businesses that may be ineligible for financing.

* * * * *

(b) * * *

(2) Exception for pass-through of proceeds to subsidiary. You may finance a passive business if it is a Small Business and it passes substantially all the proceeds through to one or more subsidiary companies, each of which is an eligible Small Business that is not passive. For the purpose of this paragraph (b)(2), “subsidiary company” means a company in which the Financed passive business either:

(i) Directly owns at least 50 percent of the outstanding voting securities; or

(ii) Indirectly owns at least 50 percent of the outstanding voting securities (by directly owning the outstanding voting securities of another passive Small Business that is the direct owner of the outstanding voting securities of the subsidiary company).

* * * * *

(c) Real Estate Businesses. (1) You are not permitted to finance any business classified under North American Industry Classification System (NAICS) codes 531110 (lessors of residential buildings and dwellings), 531120 (lessors of nonresidential buildings except miniwarehouses), 531190 (lessors of other real estate property), 237210 (land subdivision), or 236117 (new housing for-sale builders). You are not permitted to finance any business classified under NAICS codes 236118 (residential remodelers), 236210 (industrial building construction), or 236220 (commercial and institutional building construction), if such business is primarily engaged in construction or renovation of properties on its own account rather than as a hired contractor. You are permitted to finance a business classified under NAICS codes 531210 (offices of real estate agents and brokers), 531311 (residential property managers), 531312 (nonresidential property

managers), 531320 (offices of real estate appraisers), or 531390 (other activities related to real estate), only if such business derives at least 80 percent of its revenue from non-Affiliate sources.

(2) You are not permitted to finance a Small Business, regardless of NAICS classification, if the Financing is to be used to acquire or refinance real property, unless the Small Business:

* * * * *

5. Amend §107.1120 by revising paragraphs (e) and (f) to read as follows:

§107.1120 General eligibility requirements for Leverage.

* * * * *

(e) For any Leverage request pursuant to § 107.1150(d)(2)(i), certify that at least 50 percent (in dollars) of your Financings made on or after the date of such request will be invested in Small Businesses located in low-income geographic areas.

(f) For any Leverage request pursuant to § 107.1150(d)(2)(ii), certify that at least 50 percent (in dollars) of the Financings made by each Licensee under Common Control on or after the date of such request will be invested in Small Businesses located in low-income geographic areas.

* * * * *

6. Amend §107.1150 by revising the first and second sentences of the introductory text and paragraphs (d) introductory text, (d)(1)(iii) and (iv), the first sentence of (d)(2), (e)(1), and (e)(2)(iii) and (iv) to read as follows:

§ 107.1150 Maximum amount of Leverage for a Section 301(c) Licensee.

A Section 301(c) Licensee, other than an Early Stage SBIC, may have maximum outstanding Leverage as set forth in paragraphs (a), (b), (d), and (e) of this section. An Early Stage SBIC may have maximum outstanding Leverage as set forth in paragraph (c) of this section. * * *

* * * * *

(d) Additional Leverage based on investment in low-income geographic areas. Subject to SBA's credit policies, you may have outstanding Leverage in excess of the amounts permitted by paragraphs (a) and (b) of this section in accordance with this paragraph (d). If you were licensed before October 1, 2009, you may seek additional Leverage under paragraph (d)(1) only. If you were licensed on or after October 1, 2009, you may seek additional Leverage under paragraph (d)(1) or (2), but not both. In this paragraph (d), "low income geographic areas" are as defined in § 108.50 of this chapter. Any investment that you use as a basis to seek additional leverage under this paragraph (d) cannot also be used to seek additional leverage under paragraph (e) of this section.

(1) * * *

(iii) Subtract from your outstanding Leverage the lesser of paragraph (d)(1)(i) or (ii).

(iv) If the amount calculated in paragraph (d)(1)(iii) is less than the maximum leverage determined under paragraph (a) of this section, the difference between the two amounts equals your additional Leverage availability.

(2) Investment in Small Businesses located in low-income geographic areas. This paragraph (d)(2) applies only to Licensees licensed on or after October 1, 2009. ***

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(e) Additional Leverage based on Energy Saving Qualified Investments in Smaller Enterprises. (1) Subject to SBA's credit policies, if you were licensed on or after October 1, 2008, you may have outstanding Leverage in excess of the amounts permitted by paragraphs (a) and (b) of this section in accordance with this paragraph (e). Any investment that you use as a basis to seek additional Leverage under this paragraph (e) cannot also be used to seek additional Leverage under paragraph (d) of this section.

* * * * *

(2) * * *

(iii) Subtract from your outstanding Leverage the lesser of paragraph (e)(2)(i) or (ii).

(iv) If the amount calculated in paragraph (e)(2)(iii) is less than the maximum Leverage determined under paragraph (a) of this section, the difference between the two amounts equals your additional Leverage availability.

Maria Contreras-Sweet,
Administrator.

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